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IRS Fact Sheet

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2002 TAX LAW CHANGES: EDUCATION INCENTIVES

While taxpayers will encounter only a handful of tax law changes when doing their tax returns this spring, they should be aware of some wide-ranging changes for 2002 related to education expenses. Many of these will require action on the part of taxpayers to benefit from them.

Coverdell Education Savings Accounts (ESAs)

Coverdell ESAs – formerly known as Education IRAs – do not give any immediate tax benefit, but they allow beneficiaries to accrue tax-free earnings for qualifying educational expenses. Several changes relate to the contribution rules:

- The annual contribution limit has been raised from $500 to $2,000 per beneficiary.
- The income eligibility for married contributors has been raised to $190,000. As a couple's income increases from $190,000 to $220,000 – which is double the range for unmarried persons – their contribution limit phases out.
- Corporations, including tax-exempt organizations, may now be contributors, regardless of income level.
- The deadline for contributions for a given year will be the due date of the contributor's tax return, without extensions, instead of December 31.
- A beneficiary may have contributions made to both a Coverdell ESA and a state tuition program in the same year.

More distributions from Coverdell ESAs will qualify for tax-free treatment, thanks to these changes which take effect in 2002:

- Qualifying educational expenses now include certain elementary and secondary school costs.
- College students who use Coverdell ESA funds may also claim the Hope or Lifetime Learning Credits, as long as the credits are claimed for different expenses than those paid from the ESA funds.

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- While most beneficiaries must use up their ESA accounts before age 30 or transfer them to a qualified relative, there is no longer an age limit for special needs beneficiaries.

Qualified Tuition Programs (QTPs)

Certain states offer programs that allow people to prepay a student’s tuition or contribute to a higher education savings account. The new law extends the tax benefits related to such programs to tuition prepayment programs offered by educational institutions. As before, payments or contributions to a QTP are not deductible. But several changes will increase the tax benefits of distributions from QTPs:

- Distributions from state programs are now tax-free to the extent they are used for certain qualifying higher education expenses. The same tax-free treatment will apply to the prepaid tuition programs of educational institutions, but not until 2004.

- The prior law's dollar limits for qualifying room and board expenses for students living off-campus are changed to reflect the educational institution's published "cost of attendance" amounts.

- Students receiving tax-free benefits from QTPs will also be allowed to claim the Hope or Lifetime Learning credits or receive a tax-free distribution from a Coverdell Education Savings Account, as long as the different programs do not pay for the same expenses.

- Benefits may now be rolled over from one QTP to another for the same beneficiary, but only once within a 12-month period.

- For rollover and change of beneficiary purposes, the term “family member” now includes first cousins of the original beneficiary. A designated beneficiary may be changed to a family member, or an amount rolled over to a family member’s QTP within 60 days of distribution, without tax consequences.

- Expenses of a special needs beneficiary that are necessary in connection with that person’s higher education are now qualifying expenses for a QTP.

- Distributions not used for qualified higher education expenses are now subject to an additional 10% tax.

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Deduction for Higher Education Expenses

Taxpayers with incomes up to $65,000 ($130,000 on a joint return) may deduct up to $3,000 of qualified higher education expenses for courses during 2002. They will not have to itemize deductions on Schedule A to claim this benefit. Persons who may be claimed as dependents, and married persons filing separately, are not eligible for this deduction.

A taxpayer may not claim both this deduction and a tax credit for education expenses for the same student in one year. A taxpayer who has higher education expenses which are paid by a tax-free distribution from a Coverdell ESA, a qualified tuition program, or an education savings bond, may not use the same expenses for this deduction.

Employer-provided Educational Assistance

Employers may provide their workers with up to $5,250 a year in tax-free educational benefits. This provision, which would have expired at the end of 2001, is now a permanent tax benefit. It has also been extended to apply to graduate studies, for courses beginning after 2001.

Student Loan Interest Deduction

Interest on student loans for higher education may now be deducted whenever paid and regardless of the age of the loan. Prior to 2002, only payments made within the first 60 months of the required repayment term counted. Voluntary payments – for example, those made before the student graduated – did not qualify for the deduction.

This deduction is now available to taxpayers with incomes up to $65,000, with the deduction amount phasing out as income increases above $50,000. For married couples filing jointly, these figures are doubled. Previously, the phaseout range was $40,000 - $55,000 of income ($60,000 - $75,000, joint returns).

Tax-Free Scholarships

Although scholarships are usually taxable if they carry a future service requirement, tuition, books and other equipment paid for by National Health Service Corps or Armed Forces Scholarship Programs will not be taxed. This benefit does not extend to room and board payments under these programs.

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